"Only those who risk going too far can possibly find out how far one can go." T.S. Eliot

"Risk means more things can happen than will happen." Elroy Dimson, London Business School

"IMF cuts growth forecast, warns on inflation" The lead headline in last week's (October 13, 2021) Wall Street Journal succinctly sums up the challenge for investors as we move into the final quarter of the year. Rising inflation, slowing growth – shades of a 1970's style stagflation anyone? While it would be easy to take this narrative and run with it, our experience has been to take any "forecasting" from the IMF (or any central bank, including our Federal Reserve) with a grain of salt. It is however these two variables, growth and inflation, that are ultimately critical to our assessment of risks and opportunities in capital markets. While the two are correlated, we are going to address each individually as they potentially impact markets. On the growth front, the news is seemingly more favorable. After slowing growth over the course of the summer associated with the rise of the Delta variant and related lockdowns, the potential for a reacceleration in global economic growth is supported by the following:

- The Goldman Sachs effective lockdown measure is at its lowest level since the start of the pandemic.
- 45% of the world's population, approximately 3.5 billion people, have now received at least one vaccine shot. India is administering one million shots per day. Additionally, new medications (Merck) are reaching the market.
- Households have $2.4T of excess savings (15% of annual consumption), a tailwind for consumer spending while unemployment rates have declined below 5%.
- Monetary policy remains highly accommodative even in the face of the coming taper of extraordinary asset purchases.
- Budget deficits are likely to provide a fiscal boost to the economy.
- A positive yield curve reflects continued favorable liquidity conditions suggesting the odds of recession are low.

While the outlook for a pickup in global growth remains favorable, building inflationary pressures represent a critical variable for financial markets. Over the course of the last forty years, rising inflation has been met with tightening monetary policies by central banks designed to slow growth and inflation. The Federal Reserve's commitment to the mandate of price stability, and the market's confidence in this commitment, had a meaningful impact on markets with low inflation and falling

interest rates supporting rising asset prices. However, at the risk of stating the most dangerous words in finance, this time appears to be different:

- The Federal Reserve's influence on the overall economy has increased as a result of the size of the financial assets relative to the overall economy, suggesting smaller changes in monetary policy may have outsized impacts on the economy.

- Statements and actions to date out of the Federal Reserve suggest the social mandate component (full employment) of their dual mandate holds greater sway versus price stability.

- Rising energy prices appear sustainable in the face of Green energy mandates restricting the normal investment response to higher prices by the oil and gas sector.

- At a current ratio of 1.25 job openings per unemployed worker, labor force tightness suggests continued pressure on wages.

- Anecdotally, the largest increase in the cost-of-living adjustment for social security benefits in forty years seemingly contradicts the narrative that inflationary pressures are transitory.

Last quarter, we spoke of markets in a "classic mid cycle transition", where markets navigate the shift from liquidity driven expectations of growth to a potentially self-sustaining economy allowing interest rates to normalize. However, this cycle does indeed appear to be different… current Federal Reserve policy reflects a willingness to let the economy "run hot" for an extended period of time, suggesting higher inflation and ultimately higher interest rates. The implications for financial markets are significant. Stronger growth and higher rates would be a headwind for the stock market index domestically given the inherent strong growth bias in the structure of the index. Negative real interest rates will remain a headwind for fixed income markets while a potential boost for real assets. Volatility is likely to increase in fixed income and equity markets while starting valuations suggest muted returns.

In this environment, risk management will take on increasing importance as excess and speculation in markets should moderate, if not sharply correct. We have taken steps in client portfolios to rebalance allocations back to strategic targets in anticipation of increasing volatility but remain positioned for longer term growth. It is our strong conviction that the equity investments that we hold in client portfolios represent a favorable combination of strong earnings growth characteristics and attractive valuations. Conversely, the broader market remains highly concentrated with potentially aggressive earnings growth expectations and stretched valuations. In fixed income investments, we continue to limit maturity exposure while introducing

alternative investments to portfolio allocations to boost expected returns.

The Federal Reserve is in the midst of a challenging tap dance between supporting growth and moderating inflation. While the range of outcomes remains wide, we are focused on positioning portfolios in growing assets with an acceptable margin of safety while maintaining appropriate levels of liquidity for our clients' specific situation.

We appreciate the confidence you have placed in our firm and look forward to discussing your portfolio with you.

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